Investment Advisor
THE VOICE OF INDEPENDENTS

Getting Your Shares

Advisors' use of ETFs in client portfolios is growing more sophisticated as their options increase

- James J. Green

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Advisor Mike Patton of Integrity Wealth Management in Baton Rouge, Louisiana, thinks highly of exchange traded funds in building client portfolios since they are relatively low-cost, tax-efficient ways to capture the entire market or slices of the market—a cheap, tax-sensitive, liquid alternative to index mutual funds. Advisor Gene Balliett of Balliett Financial Services in Winter Haven, Florida, likes ETFs for different reasons. He believes that certain ETFs can help him in his continuous quest for absolute return vehicles, including inverse ETFs that capture double the beta of major market indexes—one of the only ways in the current market atmosphere to produce alpha in a market where everything, including most fixed-income investments, is in the red. These two advisors represent the two ends of the spectrum when it comes to advisor use of ETFs in client portfolios, and both are appropriate approaches, according to product manufacturers, money managers, consultants, and other advisors interviewed on the subject.

Sue Thompson, who runs the RIA channel of Barclays Global's U.S. iShares business, says it's been "an amazing journey to see the variety of ways that advisors use ETFs in their portfolios." She cites the core/satellite approach to portfolio building as an example. Normally, she says "we think of that as indexing the core and doing active management in the satellites. But many clients take the opposite approach. Their core is a group of stocks on which they've done fundamental analysis, and their satellite is the ETFs. They may not have expertise in emerging markets, for example, so they decide to index that. It's almost a reverse core/satellite."

Like those Thompson cites, more and more advisors are incorporating ETFs into client portfolios, helping to increase the pace at which money is being invested into ETFs since their introduction almost 16 years ago (the SPDR was introduced January 29, 1993). Even this year, when the assets in United States-listed ETFs fell 6.6% through the end of the third quarter, they held up much better than the value of, say, the MSCI U.S. index, which fell 20.52%, according to Barclays Global Investors, the largest manager of ETFs in the U.S.

In 2008 alone, another 103 ETFs were launched in the U.S., bringing the total up to 681 holding $542 billion in assets, including the first actively traded equity ETFs, which must disclose their portfolio holdings *(see chart on following page displaying the growth of ETFs over the years).* Moreover, there are an additional 486 ETFs planned for launch in the U.S., Barclays reports, though some of those may be postponed indefinitely due to the current market freefall.

In fact, the growth of ETFs, and the flexibility that they offer in constructing portfolios, is leading some experts to suggest that ETFs might challenge mutual funds' hegemony in the near future.

A Threat to Mutual Funds?
Cerulli Associates' Director Cindy Zarker wrote starkly in an August 2008 report, *Product Development in an Evolving Portfolio Construction Environment*, that "ETFs are a potential threat to mutual funds," reporting that

advisors are using ETFs in both "core and satellite allocations, as well as in the active and passive slices of investors' portfolios." Zarker notes that advisors who are strategic asset allocators are "likely more interested in ETFs for their lower fees and long-term investment themes," while advisors who employ a tactical asset allocation approach may use ETFs "because they offer continuous liquidity and access to commodities and other markets where they want to make a concentrated bet."

While Balliett argues that "ETFs will drive a lot of mutual funds out of business," the vehicles have a long way to go to challenge mutual funds over all, of course.

As of the end of August 2008, the most recent month for which we had data as of press time, there was $11.578 trillion resting, uncomfortably these days, in 8,081 U.S. mutual funds, according to the Investment Company Institute. The woes of September and early October would have put a big dent in that amount, particularly in the money market funds, which had $3.520 trillion in 800 funds as of August, and which had seen $343 billion in net new inflows for the year-to-date through August. But as is the case with advisors who use a range of alternative investments to capture alpha and diversify client portfolios, advisors who are heavy users of ETFs are often among the leaders of the profession.

Plain Vanilla and Tutti Frutti

Natalie Lera, vice president for product management at Schwab Institutional, acknowledges that ETFs are a "large part of how our advisors round out portfolios, and they're growing."

She recalls that a few categories of ETFs have been tried where people said at the end of the day, 'You know, this is not a great application for an ETF,'" citing in particular the attempt earlier in 2008 that "tried to track the price of oil, and they didn't do too well. Do I think we'll have more ETFs that track oil? Yes. Will they do so in the same way? Probably not."

"ETFs have become a more popular tool," says Ed Lopez, director of ETF strategies for Rydex Investments. "As mutual fund providers, we know ETF usage has outpaced individual stock usage in 2008." Research conducted by Rydex AdvisorBenchmarking among RIAs found that almost three-quarters of advisors now use ETFs in building client portfolios, and that 37% of advisors surveyed by Rydex AdvisorBenchmarking chose ETFs "as the number one investment vehicle that has helped them increase business since 2001." *(Disclosure: Rydex AdvisorBenchmarking and Investment Advisor have a content sharing relationship under which Rydex provides research data monthly for the IA "Practice Edge" electronic newsletter.)*

What accounts for the attraction of ETFs? Lopez ticks off the standard ones: cost, ease of use, access to specific market segments, and diversification, noting the popularity this year among advisors of Rydex's eight CurrencyShares ETFs and commodity ETFs. Sector ETFs, Lopex says, allows advisors to be more "flexible and dynamic with client portfolios." Speaking on October 6, Lopez said Rydex was seeing good inflows lately to consumer staples ETFs, and outflows from oil funds. He noted that energy ETFs had posted 30% positive gains by mid-year 2008, but that the trend then reversed.

Another growing use of ETFs among advisors is to hedge client portfolios, which is why Lopez has seen more interest in leveraged and inverse products—a specialty of Rydex and ProFunds—particularly in inverse financials ETFs. He's also seen good flows to the bond ETFs during the recent market turmoil. It's been a big focus of Rydex to educate advisors, says Lopez, mentioning in particular a Rydex publication called *ETF Essentials*. Balliett is one of those advisors who doesn't need convincing. He uses Rydex because of their "long list of mutual funds and ETFs that are no-load, many are inverse, and with no transaction fees." It gives him a "way to diversify within a sector," being able to buy 12 stocks in a sector, for instance, and only pay one commission rather than 12. He notes that it's "easier to pick a sector that will bloom, rather than the one leader in that sector." Moreover, amid the current market strife, the inverse funds in particular provide "opportunities to soften the down side," Balliett says (he also recommends **www.ETFConnect.com** for advisors looking for more education on exchange traded funds).

Tactical and Practical

While Lera of Schwab Institutional warns that "ETFs are not all things to all people," advisors are certainly using them in multiple ways to meet the needs of clients. Thompson of Barclays recalls the "huge demand last October for the first municipal bond ETF. People were looking for more fixed-income alternatives." Another appealing introduction, she says, is when iShares "expanded our fixed-income suite with a very, very short-term Treasury (SHV). Especially in this environment that has been massively popular as a place to park [assets] as people were figuring out what to do—it's not a cash fund, but it's a very liquid, safe alternative."

Thompson says she's seen a "huge difference" on how advisors use ETFs on the fixed-income side. "Five years ago, very few advisors were using fixed-income ETFs," she says, "and frankly there weren't that many out. The suite of products has broadened tremendously, as have the tools. We see people completely moving into ETFs for the entire part of their fixed-income allocation, or they're still laddering bonds for the first five years, and then, to reduce callability risk, for instance, they'll push the balance of the fixed income portfolio out into an ETF that has a longer duration, since you're not looking for the current coupon amount."

Thompson says she knows of at least 30 RIAs who run all-ETF portfolios. "For some, it's strategic, but many are using them much more tactically, doing global sector rotation strategies, for instance; using a beta product to create alpha." Those advisors cite the classic Brinson, Beebower study "on how more than 90% of the variability of returns comes from asset allocation and a very small amount from security selection. So if they choose the right asset classes to be in at the right time, why not implement that using a very inexpensive product like an ETF? That's the registered investment advisor as alpha generator."

Dan O'Neill, chief investment strategist for Direxion Funds, reported that as of early October, short ETFs and ETNs were doing well. "Initial ETFs were broad-based indexes for long-term investors," but now, you're seeing the creation of vehicles that are more tactical," mentioning in particular ProShares as "the great success story" in tactical ETF investing. But the original purposes of low-cost index funds are "still good ideas," says O'Neill, though the newer varieties of leveraged and inverse ETFs allow "investors to become more athletic."

Direxion was first to market in May with a family of 36 funds that will provide triple the performance, or inverse, of the major U.S. and many foreign indexes, and while "leverage" is a dirty word these days and O'Neill admits that "people will say these products are crazy," he argues that isn't the case if you "use them in a sober, measured way" and if the leveraged ETFs are seen "in the context of the overall portfolio."

ETFs With Training Wheels

So if you're not crazy about leverage, and more comfortable with a '40 Act fund, maybe you'd like to explore a mutual fund of ETFs, like that provided by Jim Porter at Aston/New Century Absolute Return ETF Fund (ANENX), which launched in March of this year, though he has been running the all-ETF portfolio since 2004. "Maybe an advisor starts with us," says Porter, "and gets comfortable with the idea of having ETFs in their clients' portfolios." In speaking to advisors around the country, Porter says they are receptive to the idea that, "ETFs give you a fabulous opportunity to strive for absolute returns, because you have all the asset classes—you can even buy 90-day T-Bills." Porter says his fund's holdings this year have had "as much as 40% cash and 20% inverse and 17% bonds, some commodities, and some currency. How alternative can you get!"

Regarding the active/passive debate, Porter says he "can't even imagine managing a portfolio in these kinds of markets without using active management. I can't stand the thought of being a passenger. The ETFs are very conducive to active management: the executions are instantaneous, and many of them are to four places." He's quick to admit there are "a lot of caveats you have to put on them—especially the thinly traded ones, and the inverse ones, and warns that "you don't use market orders." But he says ETFs are a great way to do "style and market cap rotation during an economic cycle while doing a sector rotation; it's a great place to get alpha."

Another manager with a similar idea is Kevin Mahn, chief investment strategist for SmartGrowth Funds, which launched in June 2007 three funds that combine "asset allocation with ETFs in a '40 Act fund using Lipper's Optimal indexes on January 1, 2007; we launched our SmartGrowth funds in June 2007 which tracked those indexes. Mahn says SmartGrowth's approach reflects what "many advisors and individual investors are starting to realize: that the depth of ETFs that are in the marketplace, with the ability to go long and short certain asset classes and sectors, and the ability to access foreign currency markets and commodities, in such an easy and convenient manner of an ETF, is affording an ability to build really cost-efficient portfolios. We obviously think investors and advisors would be best served by picking our funds and letting Lipper and us do all the work, but a lot of advisors now, if you look at their own portfolios, are including ETFs for the same reasons I pointed out."

Advisors are using the funds in wraps, Mahn says, and reports that others are using them as their alternatives asset class allocation, "since we offer a lot of downside protection." Others are using them in their IRA accounts for clients, he says, since they "are a great tool to build diversified growth, rebalanced on a quarterly basis. I get my load up front, I get my 12(b)-1 in perpetuity and my clients are happy." Mahn says ETFs have had difficulty penetrating the "Holy Grail of asset gatherers, the 401(k) marketplace," partly because the plan "recordkeepers' systems don't have the ability to process ETFs that trade throughout the day instead of capturing NAV at the end of the day like a '40 Act fund *(for more on the role of ETFs in retirement plans, see sidebar on page 82).*

The Future

Lopez of Rydex believes that more assets will move to ETFs, especially if the "industry can crack the retirement space," and that active ETFs "may spur growth" as well. Lera of Schwab Institutional notes that since there is an "an overabundance of ETFs in some areas, it's likely there will be some culling as a natural part of the product development lifecycle." While she doesn't see too much demand for or adoption of mutual funds of ETFs, she thinks advisors are increasingly adopting ETF wraps, which first had their debut in the wirehouses but are finding wider acceptance for their cost-efficiency and transparency.

Thompson of Barclays argues that "Coming out with me-too products doesn't do anybody any good, but there are aspects of the market where you can get true diversification where there are currently not any products." Some could be easy to do; others would be more difficult. "I can't tell you how many times advisors have asked for an ETF," she says, "on the VIX [the CBOE's volatility measure].

To the question of whether there are too many ETFs Porter of the Aston/New Century ETF fund responds, "There are too many, and there aren't enough. We have some things we don't need, and we don't have some things we do." Among the "not enough" are those in "subsectors like technology and infrastructure, and alternative energy like wind—we just need more companies to make an ETF."

Thompson uses 2008 as a timely example of another feature of ETFs. "What's going to happen is that you're going to have an awful lot of mutual funds that, come December, will be distributing cap gains that clients will need to pay tax on," she predicts. "If you can have a structure that minimizes that—and keep in mind that ETFs are not immune from cap gains, but they do tend to be minimal compared to their mutual fund counterpart, so it becomes a viable option." If, she says, you expect returns to be lower, "the things that you can control are cost and taxes, and advisors are going to seize on those kinds of solutions."

SIDEBAR

The Retirement Angle

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